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THE WHITE HOUSE
WASHINGTON

CABINET AFFAIRS STAFFING MEMORANDUM

Date: 6/17/85 **Number:** 316952CA **Due By:** 18 Jun 85

Subject: Economic Policy Council Meeting: Tuesday, June 18, 1985 - 2:00 P.M. - Roosevelt Room

Corporate Takeover
G-10 Toyko mtg

	Action	FYI
ALL CABINET MEMBERS	☐	☐
Vice President	☑	☐
State	☑	☐
Treasury	☑	☐
Defense	☐	☐
Justice	☐	☐
Interior	☐	☐
Agriculture	☑	☐
Commerce	☑	☐
Labor	☑	☐
HHS	☐	☐
HUD	☐	☐
Transportation	☑	☐
Energy	☐	☐
Education	☐	☐
OMB	☑	☐
CIA	☑	☐
UN	☐	☐
USTR	☑	☐
Chief of Staff	☑	☐
GSA	☐	☐
EPA	☐	☐
NASA	☐	☐
OPM	☐	☐
VA	☐	☐
SBA	☐	☐

	Action	FYI
CEA	☑	☐
CEQ	☐	☐
OSTP	☐	☐
Mc Farlane	☑	☐
Svahn	☑	☐
Chew *(For WH Staffing)*	☑	☐
Executive Secretary for:		
DPC	☐	☐
EPC	☑	☐

REMARKS: There will be a meeting of the Economic Policy Council on Tuesday, June 18, at 2:00 P.M. in the Roosevelt Room.

The agenda will be (1) Corporate Takeover Legislation; and (2) G-10 Meeting in Tokyo. Background papers for Corporate Takeover Legislation are attached. No papers will be circulated for the G-10 Meeting in Tokyo prior to the meeting.

RETURN TO:

☑ Alfred H. Kingon
Cabinet Secretary
456-2823
(Ground Floor, West Wing)

☐ Don Clarey
☐ Tom Gibson
☐ Larry Herbolsheimer

Associate Director
Office of Cabinet Affairs
456-2800 (Room 129, OEOB)

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THE WHITE HOUSE

WASHINGTON

June 17, 1985

MEMORANDUM FOR THE ECONOMIC POLICY COUNCIL

FROM: ROGER B. PORTER RBP

SUBJECT: Agenda and Paper for the June 18 Meeting

The agenda and paper for the June 18 meeting of the Economic Policy Council are attached. The meeting is scheduled for 2:00 p.m. in the Roosevelt Room.

The first agenda item conerns corporate takeover legislation. Douglas Ginsburg, chairman of the Working Group on Corporate Takeovers, will bring the Council up to date on developments affecting the prospects for corporate takeover legislation with particular reference to several bills that have been introduced in this Congress that would restrict the use of high-yield securities. A memorandum for the Council on "'Junk Bond' Legislation and Depository Institutions" is attached.

The second agenda item concerns the upcoming G-10 meetings in Tokyo later this week. No paper will be circulated for this agenda item in advance of the meeting.

Attachments

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THE WHITE HOUSE

WASHINGTON

ECONOMIC POLICY COUNCIL

June 18, 1985

2:00 p.m.

Roosevelt Room

AGENDA

1. Corporate Takeover Legislation
2. G-10 Meeting in Tokyo

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EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

JUN 17 1985

MEMORANDUM FOR THE ECONOMIC POLICY COUNCIL

FROM: DOUGLAS H. GINSBURG
Administrator for Information and Regulatory Affairs

SUBJECT: "Junk Bond" Legislation and Depository Institutions

Several bills have been introduced in this Congress that would restrict the use of high-yield securities.[1] One form of restriction would impose a moratorium on the use of "junk bonds" to finance most hostile takeovers.[2] A second form would disallow a deduction from taxable income of interest paid with respect to debt incurred during a hostile takeover regardless of whether the debt is in the form of a bank loan or of debt securities, whether "junk" or of investment grade.[3] A third form would impose either a permanent ban or statutory limitations on "junk bond" purchases by federally-insured depository institutions.[4]

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1 High-yield securities (also known as "junk bonds") are generally defined as publicly traded debt instruments that are either unrated or rated below the top four ratings by Moody's Investors Service or Standard and Poors Corporation.

2 S.975 (Domenici), H.R. 2400 (Richardson)

3 S. 420 (Boren), S. 476 (Boren), S. 632 (Chaffee), H.R. 1003 (Jones), H.R. 1100 (Jones), H.R. 1553 (Dorgan), H.R. 2476 (Pickle). H.R. 1553 and H.R. 2476 would apply to friendly as well as hostile takeovers of large corporations only. Treasury's Assistant Secretary Pearlman has testified in general opposition to the tax bills before both the Senate Finance Committee and the House Ways and Means Committee (see Attachment A).

4 S. 975 (Domenici), S. 1286 (Domenici), S. 1016 (Proxmire), H.R. 2400 (Richardson), H.R. 2476 (Pickle).

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These proposals all raise two basic issues:

- o Is the use of high-yield securities in corporate takeovers, which has the effect of increasing corporate debt/equity ratios, potentially harmful to the economy so as to require a Federal legislative response?

- o Does the purchase of such securities by institutions whose obligations are insured by the Federal Government undermine the safety and soundness of the financial system or expose the Federal Government to undue risk of financial loss?

Our review of the relevant evidence leads us to conclude that the answers are negative. The bills described above would serve principally to inhibit hostile takeover threats to large corporations. Insofar as they would have this effect, they are inconsistent with the President's position on corporate takeover legislation (see Attachment B). They would also deprive depository institutions of legitimate investment opportunities that may be preferable to alternative opportunities. The analysis that follows addresses the two basic issues identified above.

THE "LEVERAGING OF CORPORATE AMERICA" IS NOT DRIVEN BY JUNK BOND FINANCED HOSTILE TAKEOVERS

As an initial matter, it is useful to note that corporate debt-equity ratios are not out of line with recent economic experience, and that much of the talk about dangerous leveraging of the corporate sector has little foundation in fact. Moreover, to the extent that debt-equity ratios have risen, high-yield debt securities are not responsible for most of that increase.

According to data gathered by the Federal Reserve Board, aggregate corporate debt-capitalization ratios, measured on a market-value basis, stood at 42.2% by year-end 1984 (see Table 1, attached). Currently, the Federal Reserve estimates that, because of the recent increase in stock market values, aggregate debt-capitalization ratios stand at about 42.0%. Although the year-end 1984 figure represents an increase of 4.2 percentage points over 1983, recent ratios are in line with the experience of the 1970's and the most current ratio is lower than debt-capitalization ratios experienced in five of the last ten years.

Issuance of high-yield securities has increased greatly in recent years. Of the $59 billion in public straight debt high-yield bonds outstanding, about 40% have been issued during the last two years (1983--$8.5 billion; 1984--$15.8 billion). Such securities account for an increasing share of both new corporate bonds and new corporate borrowing (25% and 10%, respectively, in 1984).

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Nevertheless, all high-yield securities still make up only a small part (4.5%) of corporate debt outstanding; those that are related to hostile takeovers make up a much smaller part.

Critics of junk bond financed hostile takeovers cite a net decline in corporate stock issuance of $90 billion in 1984 as evidence that such takeovers are doing serious damage to the economy. Since all of the high-yield securities issued in 1984 could account at most for only 17.5% of that decline, it is clear that the principal sources of the increasing leverage are not junk bonds, but rather bank and finance company loans, commercial paper, and other bond issuances. These sources are fungible with junk bonds and can be issued for all the same purposes--corporate growth, leveraged buyouts (going private transactions), financial restructuring, and takeovers (hostile or friendly).

Although it is likely that the threat of a junk bond financed takeover has stimulated some mergers or leveraged buyouts, as well as the financial restructuring of some companies, it is impossible to assess the magnitude of their influence in these areas or to conclude whether they represented sound business judgment. What can be said is that these transactions were entered into by sophisticated investors risking either their own money or money for which they are responsible. They have every incentive to structure their deals so as to make them work, and not to enter into over-leveraged investments.

FEDERAL EXPOSURE TO "JUNK BOND" RISK IS NOT SIGNIFICANT

Federally-insured institutions are not heavily invested in high-yield securities. Bank regulators indicate that they believe bank holdings of high-yield securities are not significant, although none of the regulators currently collects data on a regular basis that address the question directly. The FHLBB staff, based on a recently completed survey, estimates that S&Ls hold about $5 billion of such securities (about one-half of one percent of total S&L assets of $1 trillion), concentrated mostly in ten large State-chartered S&Ls. Although pension funds also hold over $1 trillion in assets, a recent survey of over 100 pension fund managers found that only 3.3% invest any of their assets in high-yield securities.

A reasonably diversified portfolio of "junk bonds" appears to be a good investment. High-yield securities generally yield between 300 to 500 basis points above comparable maturity U.S. Treasury obligations. Although the default risk on these securities is greater than for investment grade securities, all studies of which we are aware have concluded that the high-yield interest rate premiums have historically been more than adequate to offset the additional risk of default. These studies covered varying periods from 1900 to 1984, but focused mostly on the last ten years. There may be somewhat greater risk in the bonds

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issued recently for leveraged buyouts and takeovers. It is much too soon, however, separately to evaluate the additional risk, if any, that takeover-related loans may pose.

Morgan Stanley estimates that the default rate on straight high-yield securities was 1.6% (160 basis points) annually from 1974 to 1984. Actual losses resulting from default were significantly lower because defaulted bonds do not become valueless. Morgan Stanley found that defaulted bonds trade at an average of 41% of par shortly after default. The value-adjusted default rate is thus about 1.06% per year, substantially below the 490-580 basis point premium to government bonds that Morgan calculates was available over the same period.

Notwithstanding this rosy historical outlook, the nature of the high-yield debt outstanding may be changing significantly with the dramatic growth in volume between 1977 and today.[5] The degree of leveraging in recent takeovers, leveraged buyouts, and restructurings is probably greater than that faced by the operating company issuers of the past. Thus, it may be inappropriate to extrapolate without qualification from this historical record and to conclude that takeover-related junk bonds will match the default experiences of past issuances.

It would also be inappropriate, however, to conclude that takeover-related junk bonds will not have a similarly positive record. These bonds are sold in competition with other high-yield instruments, and if they did not offer an adequate return, they would not be purchased by the highly sophisticated investors who buy most "junk bonds." Because of the dominance of these sophisticated investors, they, not the smaller investors such as S&Ls, set the terms of these public securities. Moreover the equity investors have every incentive to make the deal successful, since they would lose their investment first in a failure.

Finally, the risk presented by high debt-equity ratios is often relatively short-lived. Target companies often restructure themselves by selling off assets and paying down their debt, or undertaking refinancings that result in a lower debt burden.

<u>Current Federal law provides adequate authority to protect the Federal Government</u>. The general rule for investment in corporate debt securities by federally-chartered depository institutions and State banks that are members of the Federal Reserve System is that they may not invest in securities that are rated below "investment grade." Therefore, they are not allowed to hold low-rated (junk) bonds as investment securities. They are

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[5] Morgan Stanley estimates that low-rated straight public debt outstanding has grown from $8.5 billion in 1977 to $41.7 billion at the end of 1984. New issues during the same period have grown from $1 billion to $15.8 billion annually.

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allowed to own unrated (junk) bonds (subject to a prudent judgment rule) and obligations that may be transferred to their commercial loan portfolio, but they rarely do so. National banks and federally-chartered thrifts may not invest more than 10% and 15%, respectively, of their capital plus surplus in a single issue. In addition, federally-chartered thrifts are subject to a limitation on aggregate commercial loans of 10% of assets.

Likewise, State-chartered nonmember banks generally must limit investments to securities that are either investment grade or, if unrated, are "prudent." They are also subject to FDIC examination standards that may, on a case-by-case basis, revalue unrated securities or those below investment grade at market value. State-chartered thrifts are subject to State law, which generally parallels Federal law in this area except that some major States (e.g., California) have different limits on the percentage of commercial loans a thrift may hold in its portfolio. State-chartered thrifts are also subject to the same single issuer limits as Federal thrifts--15% of capital plus surplus. The FHLBB is presently considering additional rules to limit thrift investments in high-yield securities.

Both bank and thrift regulators already have the statutory authority to restrict or prohibit any unsafe or unsound practice that is likely to cause substantial dissipation of the assets or earnings of an institution, or seriously to weaken its condition. In addition, both the Vice President's Task Group on Financial Services Regulation and the CCEA have recommended that legislation be developed to enable the regulators to vary deposit insurance premiums based on objective or market-based determinants of risk.

One other source of potential Federal exposure is through pension funds guaranteed under ERISA. Pension funds are limited in their investments by a "prudent investor" standard that, given the results of the myriad studies of risk and return, should require only a reasonable amount of diversification and due diligence in order to enable them to invest significantly in high-yield securities. The employer, however, stands between the pension fund and the Federal Government; the Pension Benefit Guaranty Corporation (PBGC) would be exposed to loss only if an employer were unable to meet any unfunded liability arising from a default.

A PROHIBITION WOULD LIKELY DO MORE HARM THAN GOOD

A prohibition on federally insured depository institutions' purchase of junk bonds is unlikely to have any beneficial effect on depository institutions. Although it would stop depository institutions from investing in "junk bonds," it would not stop them from extending the same credit in the form of a commercial loan. Indeed, the commercial loan may be <u>more</u> risky since it is

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not likely to be readily marketable and is not subject to the more extensive market judgement that publicly traded securities undergo.

We have not seen any evidence to indicate either that depository institutions in general are heavily invested in these instruments, or that the investments are unduly risky. Moreover, the Federal regulators already have the authority to deal with individual problems should they arise. A prohibition will not improve the safety and soundness of depository institutions; it will merely cause the market for high-yield securities to be a little smaller--by about 5-10%. Furthermore, it would remove from the institutions a legitimate investment option that may be less risky than other available options.

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TABLE 1

DEBT-TO-CAPITAL RATIOS
NONFINANCIAL CORPORATIONS

Year	Debt (Par)[1] Equity (Current)	Debt (Par)[2] Equity (Market)	Debt (Market)[3] Equity (Market)
	percent		
1961	29.12	27.82	26.09
1962	29.81	31.32	29.78
1963	30.81	29.43	28.01
1964	31.21	28.49	27.38
1965	31.73	28.58	27.38
1966	32.17	32.62	30.26
1967	32.76	29.25	26.69
1968	33.55	28.69	26.25
1969	33.44	33.47	29.33
1970	33.66	35.35	32.43
1971	33.63	33.33	31.83
1972	33.45	32.46	31.22
1973	32.86	40.38	38.23
1974	30,48	51.27	47.67
1975	29.36	44.28	41.86
1976	29.12	42.59	42.16
1977	29.27	46.68	45.65
1978	29.14	48.66	46.67
1979	28.52	47.01	44.13
1980	27.45	41.17	37.58
1981	27.72	45.27	41.18
1982	28.58	43.71	41.55
1983	28.88	40.89	38.76
1984	32.20	44.38	42.23

1. Debt is valued at par, and equity is balance sheet net worth with tangible assets valued at replacement cost.

2. Debt is valued at par, and equity is market value of outstanding shares.

3. The market value of debt is a staff estimae based on par value and ratios of market to par value of NYSE bonds; equity is market value of outstanding shares.

Source: Based on Board of Governors of the Federal Reserve System, Flow of Funds.

May 1, 1985; Revised per May 15 memo.

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